

Legal Update

SEC Adopts Final Rules to Shorten Standard Securities Settlement Cycle From T+2 to T+1

On February 15, 2023, the U.S. Securities and Exchange Commission (the "SEC" or the "Commission") issued Release No. 34-96930 (the "Adopting Release"), containing final rules (the "Final Rules") that will shorten the standard settlement cycle for broker-dealer transactions in securities from the current two business days after the trade date ("T+2") to one business day ("T+1").¹ The Final Rules take into consideration comments to the SEC's previously proposed rules (the "Proposed Rules") in Release No. 34-94196 (the "Proposing Release") issued on February 9, 2022.² The Final Rules are part of a series of rule proposals advanced by the Commission in the aftermath of the "meme stock" events in early 2021. The compliance date for the Final Rules is May 28, 2024.

The Final Rules impose new requirements for broker-dealers as discussed further below and will require central matching services providers ("CMSPs") to take steps to facilitate straight-through processing and submit an annual report of such steps via the Electronic Data Gathering, Analysis and Retrieval system ("EDGAR").

Amendments to Rule 15c6-1, shortening the settlement cycle from T+2 to T+1

Under the Final Rules, the Commission amended 17 CFR 240.15c6-1 ("Rule 15c6-1"), shortening the standard settlement cycle for most broker-dealer transactions from T+2 to T+1. Under amended paragraph (a) of Rule 15c6-1, unless the parties expressly agree to a different settlement date at the time of the transaction, broker-dealers cannot effect or enter into a contract for the purchase or sale of a security (other than certain exempted securities identified in Rule 15c6-1) that provides for payment of funds and delivery of securities later than T+1.³

The SEC stated that shortening the standard settlement cycle to T+1 would reduce market participants' overall exposure to market risk by reducing the number and market value of unsettled trades in the U.S. clearance and settlement system; reduce the potential for systemic risk to transmit through the financial system by reducing the liquidity exposure of central counterparties ("CCPs"); and allow investors to access the proceeds of their securities transactions sooner (i.e., cash proceeds for sellers and purchased securities for buyers).⁴

In the Adopting Release, the Commission acknowledged certain difficulties that may occur in relation to foreign exchange ("FX") and cross-border transactions. For FX transactions, the Commission recognized that financing U.S. market transactions that settle on a T+1 basis with the proceeds of an FX transaction that settles on a T+2 basis may become more difficult and more costly. The Commission also considered that misalignment of settlement cycles may increase the number of fails in connection with cross-border transactions and thereby

decrease U.S. market participant's access to liquidity. However, the Commission does not believe that the misalignment of settlement cycles from a move to T+1 will increase the number of settlement fails connected with cross-border transactions, because market participants will have time to plan and prepare for the shift to T+1, to analyze whether any transaction presents a risk of settlement fail and to adjust their business practices accordingly. The Commission stated that it intends to continue to work with regulators in other jurisdictions to ensure that the move to T+1 is successfully implemented, while limiting any adverse impact on market participants who engage in both U.S. and foreign transactions.

Paragraph (b) of Rule 15c6-1 has also been amended to exclude security-based swaps from the requirements under paragraph (a) of the rule. The Commission recognized that security-based swap contracts are "generally bilateral and executory in nature" and that such contracts, unlike other securities transactions, typically include terms that expressly specify the timing of contractual obligations. The Commission thus concluded that there is no need for any rule-based "default" contract term for security-based swaps and excluded such swaps from the requirements of paragraph (a) of Rule 15c6-1.⁵ To avoid confusion, the provision exempting security-based swaps becomes effective upon the effective date of the rule (i.e. 60 days after the date of publication in the Federal Register), rather than the compliance date of May 28, 2024.

Further, under amended paragraph (c) of Rule 15c6-1, the default settlement cycle for firm commitment offerings priced after 4:30 p.m. Eastern Time is shortened from four business days after the trade date ("T+4") to T+2, unless the parties agree to a different settlement date at the time of the transaction. In the Proposed Rules, the Commission had initially considered deleting this paragraph entirely and making T+1 settlement the default for firm commitment offerings.⁶ However, in the Final Rules, the Commission instead shortened the default settlement cycle from T+4 to T+2, considering that in the event of unanticipated issues, a T+1 settlement cycle for these offerings would be insufficient time to prevent a failed settlement.⁷

New Rule 15c6-2 to facilitate same-day affirmation

The SEC also adopted a new rule under the Securities Exchange Act of 1934 (the "Exchange Act") at 17 CFR 240.25c6-2 ("Rule 15c6-2"). Under the new Rule 15c6-2, for transactions in which a post-trade allocation, confirmation or affirmation process is contemplated, broker-dealers and "other relevant parties" must either (a) enter a written agreement to complete such process as soon as technologically practicable and by the end of the trade date or (b) establish, maintain, and enforce written policies and procedures reasonably designed to ensure completion of such process as soon as technologically practicable and no later than the end of the trade date.⁸

To fulfil the stated objective to increase the rate of same-day affirmation for institutional transactions, the SEC considered that broker-dealers are best placed to modify the conduct of other relevant parties with which the broker-dealer may participate in the allocation, confirmation and affirmation process, and should bear the compliance burden under the Final Rules. Although the Proposed Rules contemplated requiring broker-dealers to enter into agreements with "customers,"⁹ the Final Rules now require that broker-dealers enter into agreements with "relevant parties" instead, better reflecting the market dynamics existing among broker-dealers, their customers, and customer's third-party intermediaries such as custodians and investment advisers in the post-trade process.¹⁰

The Final Rules include a second option that was not included in the Proposed Rules, where instead of entering into such written agreements, a broker-dealer may choose to establish, maintain and enforce written policies and procedures reasonably designed to ensure the completion of the allocation, confirmation, or affirmation for the

transaction, as soon as technologically practicable and no later than the end of the day on the trade date. For broker-dealers who choose this option, the policies and procedures must comply with the five requirements below:

- identify and describe any technology systems, operations, and processes used to coordinate with other relevant parties to ensure completion of the allocation, confirmation, or affirmation process;
- set target time frames on the trade date to complete the allocation, confirmation or affirmation process;
- describe procedures for communicating trade information promptly, investigating any discrepancies in trade information and adjusting trade information;
- describe how the broker-dealer plans to identify and address delays if another party, including an investment adviser or a custodian, is not promptly completing the allocation or affirmation for the transaction or if the broker-dealer experiences delays in promptly completing the confirmation; and
- measure, monitor and document the rates of allocations, confirmations or affirmations completed as soon as technologically practicable and no later than the end of the day on the trade date.

The SEC also made a corresponding amendment to Rule 204-2(a)(7)(iii) under the Investment Advisers Act of 1940, requiring investment advisers to keep true, accurate and current records of transactions where a broker-dealer engages in such allocation, confirmation, or affirmation process.

New Rule 17ad-27 requiring CMSPs to facilitate straight-through processing

“Straight-through processing” refers to processes that allow for automation of the entire trade process from trade execution through settlement without manual intervention. New Rule 17ad-27 under the Exchange Act would require CMSPs to establish, implement, maintain and enforce reasonably designed written policies and procedures that facilitate straight-through processing. Considering that a shorter T+1 settlement cycle may lead to expanded use of CMSPs, the SEC seeks to enhance the efficiency of CMSP services through this new rule. In addition, CMSPs would be required to submit an annual report via EDGAR that provides: (a) a summary of current policies and procedures reasonably designed to facilitate straight-through processing; (b) a qualitative description of its progress in facilitating straight-through processing during the twelve-month period covered by the report; (c) a quantitative presentation of data including specified metrics and organized in a specified manner; and (d) a qualitative description of the actions the CMSP intends to take to facilitate straight-through processing during the twelve-month period that follows the period covered by the report.

Practical Considerations

Given the new requirements applicable to broker-dealers under the Final Rules, broker-dealers should examine their business practices and procedures for compliance with the Final Rules in advance of the compliance date, May 28, 2024.

In addition, with respect to new Rule 15c6-2, broker-dealers should undertake a comprehensive review of existing written agreements with their customers, customers’ investment advisers, custodians and any other counterparties to ensure compliance with the rule’s requirements. Specifically, broker-dealers that currently manage their commercial relationships with their customers’ advisers, custodians or other agents through written agreements may wish to revise or, if such agreements do not exist, enter into written agreements that comply with Rule 15c6-

2. Alternatively, broker-dealers may choose to establish written policies and procedures that meet the requirements of paragraph (b) of the rule, as discussed above.

Broker-dealers should also consider the impact of the shortened settlement cycle on other market practices and rules that reference or are otherwise tied to the standard settlement cycle, including but not limited to the following:

- certain provisions of Regulation SHO that determine the time frames for compliance relating to sales of equity securities and fails to deliver on settlement date;
- shortened timelines for delivery of Rule 10b-10 confirmations (which must be delivered at or before completion of a transaction) and delivery of prospectuses;
- financial responsibility rules under the Exchange Act that apply to broker-dealers that explicitly or implicitly reference the settlement date of a securities transaction;
- the time period within which a broker-dealer must obtain cash payment or margin from a customer for a securities transaction under Regulation T; and
- certain rules by self-regulatory organizations (such as the Financial Industry Regulatory Authority, Inc. or The Options Clearing Corporation) that reference the existing Rule 15c6-1 or currently define “regular way” settlement as occurring on a T+2 basis.

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ENDNOTES

¹ See Securities and Exchange Commission, *Shortening the Securities Transaction Settlement Cycle*, Release No. 34-96930 (February 15, 2023), available at <https://www.sec.gov/rules/final/2023/34-96930.pdf> (the “Adopting Release”)

² See Securities and Exchange Commission, *Shortening the Securities Transaction Settlement Cycle*, Release No. 34-94196 (February 9, 2022), available at <https://www.sec.gov/rules/proposed/2022/34-94196.pdf> (the “Proposing Release”)

³ Securities that are exempted from Rule 15c6-1 include “an exempted security, a government security, a municipal security, commercial paper, bankers' acceptances, or commercial bills”. See Adopting Release, Rule 15c5-1(a), at p. 309.

⁴ *Id.* at pp. 38-44.

⁵ *Id.* at p. 47.

⁶ *Proposing Release*, at p. 46.

⁷ *Adopting Release*, at p. 51-55.

⁸ *Id.* at p. 60.

⁹ *Proposing Release* at p. 64.

¹⁰ See *Adopting Release* at n. 205-6 and accompanying text.

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